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reasonable method to insure that the debt reduction objective of the funded depreciation account is accomplished.

Statement of Need:

Subitem 8 describes how other funded depreciation and escrow accounts are to be considered with respect to the funded depreciation requirements of these rule parts. It is necessary to clarify this issue since many providers have funded depreciation accounts required by other financing institutions.

Reasonableness:

It is reasonable to allow the required Depreciation Reserve of the Minnesota Housing Finance Agency to fulfill the funded depreciation requirements of these rule parts since both accounts have similar objectives and requirements.

On the other hand, the Development Cost Escrow Account required by the same agency is excess borrowing designed to secure the loan from possible default. This account has no relation to the payment of depreciation and its purpose is not related to the objectives of the funded depreciation account in this item. Therefore, this account and similar accounts do not fulfill the requirements of this item.

Statement of Need:

Subpart 2 item A establishes limits on interest rates. It fulfills the mandate to set "limits on the amounts of reimbursement for property, general and administration, and new facilities," Minnesota Statutes, section 256B.501, subdivision 3. Additionally, this subpart addresses recommendation contained in LAC Report, (p. 62.)

Item A of this subpart limits interest on allowable capital debts entered into after December 31, 1985 to the lesser of:

- . The effective interest rates on the debt;
- . Sixteen percent;
- . Three percentage points above the prime rate for motor vehicle capital debt; or
- . A rate 1.5 percentage points above the posted yield for conventional fixed-rate mortgages of the Federal Home Loan Mortgage Corporation for capital debt other than vehicles.

When interest rates charged are excessively high, either relative to other rates or in general, it is necessary to discourage capital formation. Therefore, limitations on interest rates are necessary as a cost containment measure and to encourage prudent management of capital assets.

Reasonableness:

When interest rates go beyond 16 percent, it is not advantageous for a business person to engage in capital formation. When interest rates over the short term are too high, investments in capital assets are usually discouraged or delayed. Since the state reimburses interest expenses to the

HCF 7- " 86-3 Date Rec'd 3-26-86
Superc. 7-22-86
State Rep. In. 1-1-86

OFFICIAL

ICFs/MR, it is necessary and reasonable for the state to limit the rate of interest that is allowable. The limitation implements the requirement that providers be reimbursed only for costs that would be incurred by an efficiently and economically operated facility and also addresses recommendations of the Legislative Auditors (LAC Report, 1983: p. 62).

It is reasonable to limit interest rates on capital debt, other than motor vehicles, to 1.5 percentage points above the posted yield for standard conventional fixed-rate mortgages of the Federal Home Loan Mortgage Corporation. This rate, commonly referred to as Freddie Mac, is reflective of the commercial mortgage market for all fixed rate conventional mortgages. The limitation of 16 percent interest on capital debt is effective and necessary in a market where the cost of money is high or rising. Currently the market is changing and interest rates are declining. The limitation of 16 percent on interest rates does not affect interest costs when the market rate available is considerably lower than that limitation. The limitation on interest rates on capital debt other than motor vehicles should be dependent on a market indicator. The posted yield for standard conventional fixed rate mortgages of the Federal Home Loan Mortgage Corporation provides that indicator. The yield for Freddie Mac plus 1.5 percentage points gives a limitation on interest rates that is effective in the current market (See Table I - Interest Rates - Commercial Mortgages).

Table I - Interest Rates - Commercial Mortgages

	<u>Federal Home Loan Mortgage Corporation</u>	<u>Federal Home Loan Mortgage Corporation + 1.5</u>	<u>Market</u>
January 1, 1984	13.18	14.68	14.375(1)
July 1, 1984	14.77	16.27	14.375(1)
January 1, 1985	12.97	14.47	14.375(1)
May, 1985	12.62	14.12	14.375(1)
			13.5 - 14(2)
			12.75 - 13(3)
			13.25 - 14(4)

- (1) Minnesota Housing Finance Agency
- (2) Knutson Mortgage and Financial Corporation
- (3) Northland Mortgage
- (4) Twin City Federal Savings and Loan

Capital debt on motor vehicles: It is reasonable to use the prime rate, as published in the Minneapolis Star and Tribune, as the indicator upon which to base limitations on interest rates on motor vehicle loans since the prime rate plus three points reflects what a prudent person would pay in the current market in interest rates. (See Table II, Interest Rates, Motor Vehicles.)

It is necessary to set limitations on reimbursable interest rates since the rate charged should reflect market conditions at that time. Providers should have an incentive to negotiate more favorable interest rates or when

86-3 Date Rec'd 3-22-86
 Superce Date App'd 7-22-86
 State Rep. In. 1-1-86

OFFICIAL

interest rates are high to delay purchases until interest rates decline to more favorable levels. (LAC Report, p. xvi.)

Table II - Interest Rates - Motor Vehicles

<u>Prime Rate</u>	<u>Prime Rate Plus 3 Points</u>	<u>Market</u>
10.5 (5/15/85)	13.5	(1) 11.5 variable adjusted monthly 13 fixed rate (2) 11.34-13.25 variable 13 - 14.5 fixed rate (3) 13.25 variable 13 - 14.5 fixed rate

- (1) Norwest Bank, Minneapolis
- (2) First Bank, Minneapolis
- (3) First Bank, St. Paul

Statement of Need:

Item B is necessary in order to calculate the effective interest rate on allowable capital debt financed with adjustable or variable interest rates since the limitations on interest rates in Item A apply to adjustable and variable rates, as well as fixed rates. To do otherwise would permit a circumvention of the Department's interest rate limitations in item A.

The method of computing the effective interest rate on a debt financed with variable or adjustable interest rates is reasonable because interest expense plus points plus financing charges divided by the average allowable capital debt accurately determines the effective interest rate.

Reasonableness:

It is reasonable that allowable capital debt financed with adjustable or variable interest rates be subject to the same limitations as those financed with fixed interest rates. To do otherwise would encourage facilities to enter into allowable capital debts financed with variable or adjustable interest rates which could, in future periods, exceed the interest rate limitations. Also, it is reasonable to require that interest rates incurred not be in excess of what a borrower would have to pay in an arms-length transaction since this is one test of reasonableness.

Statement of Need:

Item C clarifies the treatment of interest rate for capital debts incurred before January 1, 1984. This provision is necessary to allow for a period of transition. The effective interest rate on capital debts incurred before January 1, 1984 is allowed if the interest rate meets the limitations in effect at the time the capital debt was incurred. During the temporary rule period, the department offered an incentive to refinance capital debt by permitting providers to keep all the savings realized during the reporting year and one-half the savings was included in the payment rate for the next rate year. After December 31, 1985, the effective interest rates on debts incurred before January 1, 1984 is subject to the interest rate limits in Item A, subitem 4.

HCF 704 86-3 Date Rec'd 3-20-86
Superc Date App'd 7-22-86
State Rep. In. V.2 Date Eff. 1-1-86

OFFICIAL

Reasonableness:

It is necessary and reasonable to permit a phase-in period and to encourage the refinancing of allowable capital debt when lower interest rates are available. The market at the present time is changing and interest rates are declining. It is necessary to set limits on interest rates on allowable capital debts incurred prior to January 1, 1984, if our reimbursement policy is to reflect what a prudent manager would do. In a market with declining interest rates, a prudent manager would refinance to reduce his/her interest expense.

Statement of Need:

Subpart 3 further circumscribes the payment of public funds for interest expense. It is necessary to set limitations on interest expense to insure prudent management of capital resources and to limit reimbursement for property costs. The LAC Report recommends that the Department develop effective limits to constrain excessive interest expense (LAC Report, 1983: p. xv).

Item A is necessary in order to explain the appropriate treatment of interest income earned on various types of invested cash deposits.

Reasonableness:

Item A. It is reasonable to distinguish between various forms of interest income available to providers or provider groups. Interest income from funded depreciation must be used for capital debt reduction or to replace, purchase or repair capital assets. Since interest income earned on funded depreciation must be used for these purposes, it would be unreasonable to offset that interest against interest expenses.

Interest income generated from amounts deposited in a Development Cost Escrow Account required by MHFA must be used to offset capital debt interest expense. The Development Cost Escrow Account required by the Minnesota Housing Finance Agency requires borrowing in excess of the historical cost of assets (112 percent) whose purpose is to secure the loan from possible default. Since excess borrowing results in additional interest expense which is not a cost that must be incurred for the quality care of residents (Minnesota Statutes, section 256B.501, subdivision 2), the offsetting of interest income on excess borrowed funds against allowable capital debt interest expense is a reasonable method of reducing the cost to the Medical Assistance Program. This is also a cost containment measure which assures the efficient and prudent management of capital assets (Minnesota Statutes, section 256B.501, subdivision 3). It should also be noted that upon retirement of the mortgage, the full amount of the Development Cost Escrow account reverts to the provider.

It is reasonable to require that interest income available to the provider from other sources be used to reduce working capital interest expense. A prudent and cost conscious business person would not needlessly incur working capital debts when such amounts of cash are available from funds available in its own accounts.

It is reasonable and necessary to allow providers to keep other interest income as an incentive for prudent management of capital assets and to give providers the opportunity to earn additional funds. As the provider's percentage of equity increases, the required deposits in the funded depre-

HCF 7c 4 86-5 Date Rec'd 3-20-86
Supercc 7-22-86
State Rep. In. 1-1-86

OFFICIAL

ciation account are reduced. Therefore, the providers will have additional funds which, if invested, could produce substantial earnings. (See Exhibit G.)

Statement of Need:

Item B is necessary to allow a period of time before requiring that capital debts entered into prior to January 1, 1984 be subject to the interest rate limitations in subpart 2, item A. The interest rates on mortgages on existing facilities shown in Table III demonstrate a wide range of interest rates. Most facilities in the sample of 259 facilities would not be affected by this item. Minnesota Statutes, section 256B.501, subdivision 3 requires limits on property costs and limits reimbursements to costs that must be incurred for the care of residents in efficiently and economically operated facilities. The LAC Report (p. 62) recommends limits on interest expense based on "maximum interest rates beyond which the state will not reimburse" (LAC Report, 1983: p. 62.) This item fulfills the legislative mandate and the LAC recommendation.

Table III. - Mortgages On Existing facilities
Long-Term Maturities
Loan Values \$25,000 or more
(as of October, 1984)

<u>Number of Mortgages</u>	<u>Amount</u>	<u>Interest Rate</u>
1	29,471	4 - 4.9
7	919,844	5 - 5.9
3	858,408	6 - 6.9
12	3,292,318	7 - 7.9
47	5,897,714	8 - 8.9
60	9,670,137	9 - 9.9
34	4,475,551	10 - 10.9
21	3,728,821	11 - 11.9
19	4,662,602	12 - 12.9
16	1,885,435	13 - 13.9
23	5,493,134	14 - 14.9
11	2,814,053	15 - 16
1	62,961	16.5 - 16.9
3	263,004	17 - 17.5
1	30,777	18
Total 259	Total \$44,084,230	

Reasonableness:

It is reasonable to expect that a prudent manager would refinance existing mortgages whose interest rates exceed market rates. To refinance in a market with declining interest rates is a reasonable decision and is consistent with the concept of a prudent manager and the objective of cost containment.

HCFA-179 # 86-3 Date Rec'd 3-20-86
Supercedes _____ Date Appr. 7-22-86
State Rep. In. V.2. Date Eff. 1-1-86

OFFICIAL

Statement of Need:

Item C is necessary in order to indicate that funds which have been restricted for the purpose of buying assets must be used for their restricted purpose before borrowing funds.

Reasonableness:

This is a necessary and reasonable cost containment provision in that it prohibits borrowing and incurring interest expense when funds are already available internally for that purpose.

Statement of Need:

Item D is necessary so that the construction period interest expense is amortized over the life of the physical plant to avoid distortion of the payment rate.

Reasonableness:

It is reasonable to spread the impact of construction period interest expense over the life of the capital asset because the construction period interest expense relates to a period of time preceding the use of the asset. Therefore, that cost benefits periods subsequent to the completion of the construction when services are being provided and benefits more than one period. This provision is in accordance with Generally Accepted Accounting Principles.

It is necessary and reasonable to establish that the construction period ends on the earlier of the date of certification for Medical Assistance, the first day a Medical Assistance recipient resides in the facility, or when the project is complete.

It is reasonable to fix a point in time when the construction period ends in order to calculate how much interest expense was incurred during the construction period.

Statement of Need and Reasonableness:

Items E and F are necessary in order to establish that interest expense shall not be allowed for the portion of capital debt which together with all other outstanding debt exceeds 100 percent of the historical capital cost of the facility's capital assets and that new acquisitions of capital assets are made with at least a 20 percent down payment. These provisions are necessary and reasonable to prevent excessive borrowing which is not necessary for the provision of care. Highly leveraged facilities are not financially stable. This situation is potentially harmful to resident care and may result in dislocation of residents. The LAC Report found high levels of indebtedness to be a serious problem in the ICF/MR industry (LAC Report, p. 55-63).

Statement of Need:

Item G is necessary in order to establish that increases in interest expense due to refinancing of existing capital debts or changes in ownership are not allowable. The Deficit Reduction Act of 1984, Public Law 98-369, section 2314 prohibits increases in reimbursement due to changes in

HC 4 86 3-20-86
Super. Date Rec'd
State Rep. In. 7-22-86
Date Appr.
1-1-86
Date Eff.

ownership. Minnesota Statutes, section 256B.501, subdivision 3 establishes that property cost must be limited and reimbursements are related to economic and efficient operations and to provision of quality care to residents. This provision is consistent with those public policies.

Subitem 1 disallows an increase in interest expense due to a sale or reorganization because it is not in the public's interest to pay for a capital asset more than once. Also, the increased cost to the Medical Assistance Program does not result in increased services to those whom the program was designed to serve, the mentally retarded citizens of Minnesota. In addition, the subitem provides for the disallowance of increases in interest expense due to refinancing. It is reasonable to disallow these increases because they are not related to resident care and they are contrary to the cost containment objective of the state. Also, a refinancing which increases the outstanding principal without a corresponding increase in capital assets results in essentially the same situation created by a sale or reorganization, namely an increase in the cost to the Medical Assistance Program without any corresponding increase in services to MR residents. It is also reasonable to permit certain exceptions to a refinancing. These are provided for in subitems 2 to 4.

Subitem 2 is necessary to provide an exception to permit refinancing of a construction period loan for a newly constructed facility provided the limits on interest rates and the amount of allowable debt are not exceeded.

Since a construction period loan is essentially interim financing for the facility during the construction phase, it is reasonable to permit a refinancing which may increase the interest expense above that paid during the construction phase. Also, it is reasonable that the provider be regulated in a way which results in consistent treatment of all providers, therefore, the same limitations imposed on other debts must also apply.

Subitem 3 is an exception which relates to capital debts with balloon payments. Refinancing of a capital debt with a balloon payment is often necessary in the current market and increases in interest expense would be allowed according to units a to c. These three units address the three elements used to determine allowable interest expense: interest rate, the amount of principal and the period of time.

Unit (a) provides for the same interest rate limitations on the refinancing of a balloon payment as the limitations applied to any other capital debt. This provides for a consistent application of the interest rate limitation among providers. Since some reduction in principal has occurred prior to the balloon payment, it is reasonable that the state should only be required to reimburse interest on the remaining portion of debt outstanding. If the amount of the refinanced capital debt were to exceed the balloon payment, the principle of cost containment and of consistent treatment of debts would not be observed. Unit (c) addresses the term or time period

OFFICIAL

over which the refinancing of the balloon payment may extend. It is reasonable to limit the term to that time period of the original capital debt computed as though there was no balloon payment since to do otherwise would permit a circumvention of the objective to contain property costs. In some instances, a capital debt with a balloon payment does not provide for the ability to determine the term beyond the balloon payment. In that case the term of the refinanced capital debt shall not extend beyond the remainder of 30 years minus the expired term of the capital debt prior to the balloon payment. A 30 year mortgage is a common length of time over which to finance a facility and is therefore reasonable. The limits in subitem (3) are established pursuant to Minnesota Statutes, section 256B.501, subdivision 3.

Statement of Need:

Subitem 4 establishes the method to determine allowable interest expense on variable or adjustable rate capital debts. Financing of capital debt using variable or adjustable rates is a viable option in the current capital market. It is necessary to set guidelines for the reimbursement of interest expense in those situations. It is also necessary that these rules must be consistent with those governing other forms of financing of capital debt.

Reasonableness:

It is reasonable to allow increases in interest expense for variable or adjustable rate capital debts provided that the average interest rate paid for each reporting year does not exceed the limit in subpart 2, item A, subitem 4.

Statement of Need:

Item H limits the cost of land purchased on or after January 1, 1984 to \$3,000 per licensed bed. This provision is necessary in order to establish the amount of capital debt in item E.

Reasonableness:

The prior reimbursement system limited the investment in land to \$1,000 per licensed bed. The Rule 53 Advisory Committee recommended that the cost of land purchased on or after January 1, 1984 be limited to \$3,000 per licensed bed. The Department believes that this amount is reasonable since \$18,000 for the land associated with a six bed facility would allow the provider to purchase land in most areas of the state. Additionally, a facility whose capital debt does not exceed 100 percent of the historical cost of the capital assets gets reimbursement for the interest expense associated with the portion of the debt related to land.

Statement of Need:

Item I is necessary to clarify the treatment of capital debts involving related organizations.

Reasonableness:

It is the state's position that there is no cost when a related organization borrows from itself since loans between related organizations are akin to loaning money to oneself. Such loans are in reality a transfer of

HC + 46-0 Date Rec'd 7-22-86
Super. Date Appr. 1-1-86
State Rep. In. 1-2-86

OFFICIAL

funds between related organizations. In addition, there is no market force or outside observer which attests to the need and validity of the transaction. For these reasons, the Department believes that it is reasonable to disallow such transactions for reimbursement purposes. Additionally, the disallowance of such interest expense correspondingly results in the disallowance of debt which results in an increase in the amount of equity. Therefore, the facility may receive an increase in its capital loan reduction allowance and will be required to fund less depreciation.

Statement of Need:

Item J establishes that charges associated with the financing of capital debt such as points, origination fees, and legal fees are costs related to the capital asset and must be amortized over the term of the capital debt. This provision is necessary to insure that the costs associated with the financing of a capital asset are spread over the period in which the debt is to be repaid.

Reasonableness:

It is reasonable to defer the impact of these costs to the periods during which the facility is used. This provision is consistent with Generally Accepted Accounting Principles.

Statement of Need:

Subpart 4 establishes the computation of the property related payment rate.

Item A describes how to determine the facility's capacity days for the reporting period. It is necessary to determine the facility's capacity days in order to determine the daily rate for property-related costs.

Reasonableness:

Since the Medical Assistance Program reimburses providers for services provided to its residents on a per diem basis, it is reasonable the facility's capacity days be determined in order that a daily rate can be established.

Statement of Need:

Item B is necessary in order to establish the method to calculate the facility's property related payment rate. The computation consists of dividing the facility's allowable property related costs by some portion of its capacity days.

Reasonableness:

As defined in the prior reimbursement rule (Parts 9510.0050 to 9510.0890) the allowable property related costs were divided by 93 percent of capacity days, to determine the facility's property related per diem. The 93 percent occupancy factor was an incentive to encourage high occupancy rates in the ICFs/MR. Also, smaller facilities of 10 beds or less received an additional benefit in that they were not penalized if their actual occupancy rate was below 93 percent. The logic was that one empty bed in a smaller facility would have a much greater per diem impact than it would in a larger facility.

HCFA-1
Supersedes
State Rep. In.
Date Rec'd
Date Appr.
Date Eff.
7-22-86
1-1-86
1-2-86

This item recognizes that the statewide average occupancy rate has been consistently high since 1976 and is currently 98 percent. This high occupancy rate reflects the demand for residential care and is not the result of the occupancy incentive. For this reason, the incentive premium in these rule parts has been reduced by replacing the 93 percent occupancy factor with a 96 percent occupancy factor. Also, since smaller facilities do not seem to be experiencing lower occupancy rates than larger facilities, a minimum occupancy factor of 85 percent has been instituted for smaller facilities. These changes were recommended by the LAC Report (LAC Report, 1983: pp. 67-69).

Item C establishes the computation of the property related payment rate by adding the property related payment per diem and the capital debt reduction allowance. This provision is necessary and reasonable to establish the facility's payment.

Subpart 5 determines the amount of the capital debt reduction allowance to be included in the property related payment rate of the facility.

- 1) To reduce the amount of allowable capital debt outstanding by the portion of the capital debt reduction allowance to be applied to reduce capital debt; and
- 2) To establish a payment which rewards the accumulation of equity as defined in part 9553.0020, subpart 18 by allowing an increase in payments to the facility as the amount of equity is increased.

This subpart is necessary and is in accordance with Minnesota Statutes, section 256B.501, subdivision 3 since it both encourages the efficient and prudent management of capital assets and rewards the accumulation of defined equity.

Item A establishes the amount of the capital debt reduction allowance to be included in a facility's payment rate at different points based upon the percentage of equity and the portion of that amount which must be applied to reduce debt.

Item B is necessary in order to state how the computation of the facility's percent of equity is to be determined.

Item C is necessary since it states what shall be done with the portion of the capital debt reduction allowance in the event the facility's capital debts cannot be prepaid.

Item D describes how the amount which must annually be applied to reduce capital debt is to be determined. This is necessary since the amounts paid during the reporting year may be different since the rate years does not cover the same period as the reporting year.

Item E is necessary to make it clear that the amount is to be used to reduce principal on capital debts in addition to the normal amortization of principle payments.

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